MAY, 1948

BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

Farm Prices in Transition

But Strong Demand Postpones Readjustments

Sharp price declines in farm products occurring in February raised the general question as to whether the economy, especially the agricultural segment of it, is entering a postwar downward price readjustment period which some believe to be inevitable, sooner or later. High employment and strong demand appear, however, to be the key factors in the situation destined to give substantial support to prices for some considerable time to come. Within an inflationary and generally high price framework some adjustments are occurring and will continue for individual farm commodities, based largely on the relative supply and demand conditions for the commodity and particularly in view of declining exports, not all of which will be sustained by the European Recovery Program. Moreover, aside from the general level of the economy, there is evidence that farm prices as a whole are still relatively high compared to other prices, at least in view of historical price relationships. Feed grain prices particularly will probably decline sharply this late summer and fall if anything like a normal feed crop is harvested. Whether some readjustment of this general relationship is under way or around the corner depends in part on the permanence of influences generated during the war period.

In the same way prospects for prices are much better for some individual commodities than for others. Much of the future of farm prices is tied up with the prospects of Congressional action this year to extend Government price support commitments beyond the end of this year. Late in April no action had been completed.

THE 1948 BREAK IN PRICES

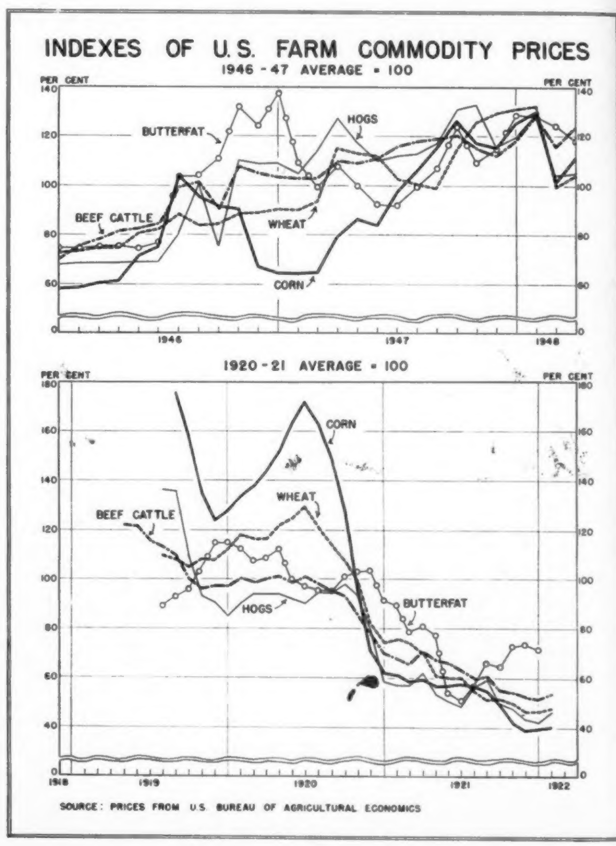
The February break in farm prices, which in part began earlier for some commodities, carried the U. S. index of prices received by farmers down nine per cent from the middle of January to mid-February. However, because this index is an average for all farm commodities it does not reflect the full extent of the declines for some commodities. For example, food grains and feed grains showed a drop of 22 per cent and 21 per cent, respectively. Oil bearing crop prices were off 12 per cent and meat animal prices 13 per cent. By the middle of March farm prices had recovered a part of these losses, but food grain and feed grain prices were 19 per cent and 13 per cent, respectively, below the January high points, and prices of oil bearing crops and meat animals were still 10 per cent below the January levels.

But these figures, based on mid-month reports by farmers on prices received, conceal some of the intervening price movements. Chicago daily prices of wheat dropped 24 per cent from the January high to the lowest point in February, and until late in April had recovered at the highest only to 17 per cent below the January figure—similarly, corn prices at Chicago dropped 29 per cent from the January high to the February low, and had by late in April reached no higher than 16 per cent below January.

The declines for the one month were of record, or near record, proportions. This was particularly true of wheat, corn, oil crops, and hogs and cattle. Such sharp breaks caused considerable apprehension, particularly because they were reminiscent of the price collapse of the 1920-21 period. They led many people to ask if the economy was not now facing a postwar shakedown comparable to that following World War I.

In spite of these sharp breaks it would appear that the current situation differs materially from the 1920-21 experience. As may be seen from the adjoining chart, the 1920 price break consisted not only of one sharp downturn, but of a series of several breaks, month after month, during the last half of 1920 and running well into 1921 for some commodities. Moreover, there was a tendency for the drops, as measured by percentage declines from the previous month, to increase their intensity as the

(Continued on Inside Back Cover)



Mortgage Trends and Homebuilding Prospects

Conflict Between Housing and Inflation Control Intensifies

How high a price—in terms of inflationary consequences—are the people in the Seventh District and the nation willing to pay to continue the present record level of homebuilding? Here is the key question which home seekers, builders, lending institutions, investors, and the Government must face during coming months. If the answer is that little further inflation is to be countenanced in housing and elsewhere, then a decline in residential construction appears probable within a year or sooner because of tightening conditions in the mortgage market. If the answer is that social considerations and rearmament needs dictate continuation of current housing output even at the cost of greater inflation in housing, then the postwar housing boom can be expected to persist.

While more than 1.3 million permanent dwelling units have been completed in the nation since the end of the war, there has been little indication until recently that increases in housing supply have more than offset new family formation. A mounting number of prospective home buyers are now finding themselves unable to enter the housing market for either new or older dwelling units. Rising down payment requirements as a result of more conservative appraisals or lower loan-value ratios constitute the principal factor underlying this trend. Mortgage lenders, institutions, and individuals, moreover, are becoming much less willing to risk their funds at high loan-value ratios, long maturities, and at interest rates which are low relative to those prevailing for alternative investments. Because of this tightening of private mortgage terms, strong pressures currently are being exerted to increase rates on Government insured loans and to create a "secondary" mortgage market through the RFC or some other Governmental agency. Many observers predict favorable Congressional action on these proposals —in other words, the answer to the question raised initially, in part at least, may well be "more inflation and more homes."

FOUR GROUPS AFFECTED

Housing finance poses an extremely knotty dilemma involving the major groups most directly concerned: (1) lenders, (2) builders and workers, (3) Government, and (4) individual buyers.

Banks, insurance companies, and other financial institutions are being requested to provide funds on high-risk, high-cost loans at rates which are no longer competitive in the capital markets generally. A 25-year Government bond currently yields 2.5 per cent; AAA corporate bonds of like maturity yield nearly three per cent; high grade preferred stocks, slightly under four per cent; and some high grade common stocks, six per cent. In contrast, insured home mortgages with maturities of 20 to 25 years and a gross rate of four per cent provide a net yield of little over three per cent. As such, they are not now attractive investments when present high prices of real estate, building materials, labor costs, and consequent risk considerations are taken into account.

Many lenders maintain that even Government guarantees cannot provide adequate protection against some of the risks involved in making mortgages under present conditions. They have in mind: (a) the possibility that sharply falling prices will adversely affect the unguaranteed portion of the mortgage, (b) probable delays and expenses in foreclosure and guarantee claim procedures, and (c) endangered public relations from widespread foreclosures. Moreover, managements of many financial institutions, especially commercial banks, now believe that their portfolios contain as large a mortgage volume as is consistent with good loan and investment policy. In some instances legal limits have become operative as well.

The costs of newly-built homes have reached the point where fewer and fewer consumers have the necessary down payment to make up the difference between the sale price and a mortgage based on conservative "long-run" appraisals of value. Consequently, contractors in the Seventh District at least are becoming progressively more dependent upon mortgages at high loan-value ratios, which in turn are also becoming more difficult to obtain.

The position of Government is no more enviable. Moral and political commitments to provide houses for veterans have been made. Since controls to implement these commitments largely have been removed, the Government's principal housing service to veterans has turned out to be insuring mortgages. The tightening of the capital markets generally in recent months, however, has made such Federal mortgage insurance terms relatively unattractive to lenders and investors, with the result that fewer veterans and others are able to complete home financing arrangements. The immediate "solution" to this problem would appear to be further easing of mortgage insurance terms. Such a policy, however, would be clearly inconsistent with the Government's broad program of inflation control.

No effective measure of changes in consumer attitudes toward inflationary price trends exists, but there is considerable evidence that many prospective home buyers no longer judge prevailing building costs in terms of those which existed in prewar years. Lack of down payment funds rather than fear of a sharp price decline seems to be the chief deterrent to new home construction, especially where needs for new living space are urgent. In numerous instances conservative expenditure plans have been, and are being, completely disregarded in the face of an acute housing situation. But in these cases the buyer has sufficient funds to obtain a mortgage.

If the number of prospective buyers able and willing

to use their own funds to finance a new house is sufficiently large, the over-all volume of residential construction in 1948 could equal that of 1947 with no liberalizing of present mortgage terms. If not, those terms either will have to be modified or else new home construction will decline.

GOVERNMENT GUARANTEE OF MORTGAGES

The experience of the Federal Government in residential mortgage insurance dates back about 15 years, but a few sections of the National Housing Act and the G I Bill of Rights are of greatest importance to the current situation. Title II, section 203, of the Act, which was widely used by home purchasers and builders during the immediate prewar period, has not been so extensively employed in recent months.[1] *Long-term value appraisals* and mortgage limits set forth in the statute have become too rigid to be very meaningful under current record high building costs.

Title VI, section 603, of the Act, a war measure, provided until March 31, 1948, for mortgage insurance up to 90 per cent of the *current costs of construction,* with an upper limit of $8,100 for a single family dwelling and an interest rate of four per cent, plus .5 per cent for mortgage insurance. A temporary extension act continues the general features of this section, except that appraisals must now be on the basis of *long-term value.* This distinction in appraisal standards, unimportant before the war when long-term appraisal value and current costs of construction were similar, obviously has real significance for both lenders and borrowers now when long-term appraisals markedly discount sharply risen construction costs.

The Veterans Administration insures construction loans for qualified veteran owners up to an amount of $4,000, or 50 per cent of the total loan, whichever is lower, in any single mortgage transaction, and at an interest rate of four per cent. In many instances, however, this mortgage insurance is combined with another mortgage, not uncommonly under section 603.

Both Title II, section 207, and Title VI, section 608, provide insurance on mortgages for multiple-unit rental housing. Section 207, however, covers only 80 per cent of the long-term appraised value and carries a rate of 4.5 per cent without the mortgage insurance charge, while section 608 insures 90 per cent of "necessary construction costs" also at a 4.5 per cent rate.

A "drying up" of Government guaranteed mortgages, i. e., section 603, section 608, and Veterans Administration, now is being reported throughout the Seventh Federal Reserve District. The underlying reasons appear to be the same everywhere. Prospective lenders have no confidence in the permanency of present housing costs and prices and deem allowable interest rates under Government mortgage guarantees to be too low, given the risks involved and alternative uses for their money. Prospective borrowers commonly find themselves unable to raise the comparatively large down payments required under prevailing appraisal policies.

MORTGAGES AND THE CAPITAL MARKET

A selective shortage of funds is now appearing along with shortages of certain materials and manpower. As seen in the April 1948 issue of *Business Conditions,* both fixed and working capital requirements of business have greatly increased during the past year. An enormous demand for private capital exists and seems likely to persist for some time.

A natural result of such a condition is a reappraisal of lending standards, with a view toward minimizing risks among alternative loans and investments, and a rise in interest rates. As a result, all types of demand for capital, including prospective home builders and contractors generally, must bid in this tighter and higher interest rate market.

Residential mortgage debt has constituted a relatively constant part, roughly one-fifth, of total *private* debt over the past two decades. Current estimates place home debt at an all-time high in absolute dollar terms, and probably in relation to all *private* debt as well. The sharp rise in *public* debt since 1940, however, has decreased the relative position of home mortgages in the total of *public* and *private* debt.

Traditionally, more than 60 per cent of the nation's home mortgage money has come from two general sources: (a) savings and loan associations, and (b) "individuals and others."[2] Mutual savings banks, commercial banks, and life insurance companies, in that order, have supplied most of the other 40 per cent.

Recent trends, however, have pointed up the increased *relative* importance of commercial banks in the financing of both the construction and purchase of homes. In 1940 commercial banks held an average of 11 per cent of all outstanding one-to-four family nonfarm residential mortgages, with a 1925-40 average of 9.4 per cent. During 1946 the commercial bank proportion moved up to 15.9 per cent, and in 1947 reached 17.5 per cent of all such mortgages. The relative importance of other types of mortgagees, except savings and loan associations, has decreased correspondingly.

From December 31, 1944, to December 31, 1947, commercial banks increased their holdings by almost 100 per cent; savings and loan associations, about 90 per cent; and "individuals and others," 40 per cent. All other types of mortgagees, however, increased their holdings by only 16 per cent.

For the major institutional lenders, except savings and loan associations, nonfarm residential mortgages constitute a relatively small part of their assets. Commercial banks have about three per cent of their total assets in home loans, life insurance companies approximately five

[1] This section provides for a fully guaranteed mortgage on new FHA inspected owner-occupied homes equal to 90 per cent of the first $6,000 of appraised (long-term) value and 80 per cent of the balance, with an over-all limit of $8,600. The maximum interest rate is 4.5 per cent, plus .5 per cent for mortgage insurance, and the maximum maturity period is 25 years. Mortgages on one-four family homes are also insured under this section up to 80 per cent of appraised value and at the same maximum rate; the maximum value may be as high as $16,000, but the maturities are limited to 20 years.

[2] Includes fiduciaries, trust departments of commercial banks, real estate and bond companies, title and mortgage companies, philanthropic and educational institutions, fraternal organizations, construction companies, RFC Mortgage Company, etc.

per cent, and mutual savings banks slightly over 14 per cent. Savings and loan associations whose business is specialized in the field have currently about 75 per cent of their total assets in mortgages, as compared with over 90 per cent in 1926. For all major institutional lenders the long-run trend since 1929 has been for mortgages to decrease in proportion to other asset holdings. This trend is largely explained by the (1) relatively low volume of residential construction during the last two decades, (2) paying-off of prewar mortgages, (3) substantial increase in holdings of Government securities, and (4) more rigid statutory limitations.

RESIDENTIAL CONSTRUCTION TRENDS

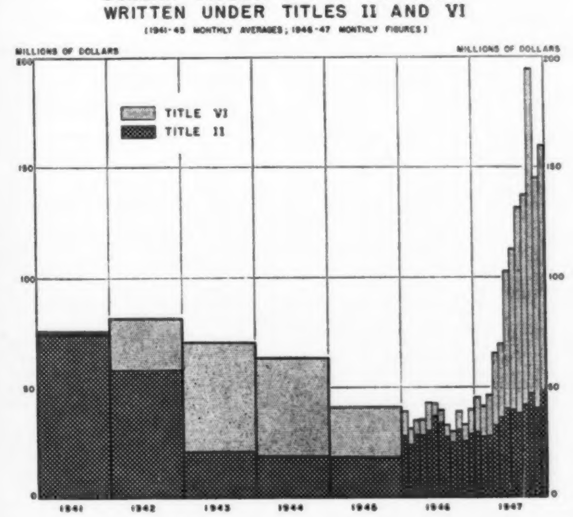
Construction contract awards to date indicate a somewhat smaller volume of new residential "starts" in the Seventh District this year than was expected early in January. Since a very large proportion of the 1947 starts took place in the last half of the year, current homebuilding activity is being carried along at a record rate by projects already begun and on which financing arrangements generally were completed some months ago.

Speculative builders in the Seventh District are being particularly hard pressed by increasing difficulty in obtaining building money. Builders of one family houses for sale, rather than on order, accounted for about 70 per cent of all starts in 1946 in the Seventh District, 55 per cent in 1947, and about 50 per cent thus far in 1948.

About 12 billion dollars in mortgage money, representing an increase in net outstandings of six billion, will be required to bring total 1948 residential starts in the nation up to the level achieved last year. Whether this money can and will be made available by institutional and individual lenders is now in doubt.

Each of the principal mortgage lender groups is showing increasing reluctance to expand its home loan volume

DOLLAR VOLUME OF FHA INSURANCE
WRITTEN UNDER TITLES II AND VI
(1941-45 MONTHLY AVERAGES; 1946-47 MONTHLY FIGURES)



SOURCE: FEDERAL HOUSING ADMINISTRATION.

for the reasons given. Highly important, there is some evidence that certain lenders deem their present mortgage portfolios to be "large enough," because of the relationship of such mortgages to invested capital, liquid assets, or total resources. To the extent to which this feeling is general, even relaxation of Government mortgage insurance terms will not stimulate much new interest in private home financing. It is not to be expected, of course, that private mortgage lenders will cease to advance funds for residential construction, but rather that they will limit such advances to borrowers with sufficient equity to reduce the lender's potential risk. Because of the almost universal practice of amortizing mortgages, moreover, it will be necessary for all lending groups to acquire new mortgages merely to maintain their outstanding mortgage volume.

It is contended by some mortgage authorities, however, that an increase of one-half of one per cent on Title VI and G I mortgage loans is all that is needed to promote a "free flow of private funds" into the general mortgage market, and also to eliminate any need for a secondary market. Whether such a rate increase actually would generate sufficient response among private lenders to keep residential building activity at its current level throughout 1948 cannot be said. It is clear, however, that many mortgage lenders are as much, if not more, concerned about the long-term risks inherent in present-day mortgages as they are in rate of return.

A higher rate accompanied by "long-term value" appraisals undoubtedly would make mortgages more attractive to most lenders, but these same conditions in all probability would limit the volume of applications for such funds because of prospective buyers' apparent inability to meet the larger down payment requirements. A higher rate together with "necessary construction cost" appraisals, on the other hand, very likely would bring some limited response from lenders and enable certain mortgages to be made which are now not possible.

It becomes rather evident that the "cost" of a continued housing boom will be added inflationary pressures in this sector of the economy, through relaxation of present Government mortgage insurance terms and conditions, and perhaps direct use of some Government funds as well. Whether this is "too high" a price to pay for new housing is a question which soon must be answered.

No abrupt decline in actual residential construction appears imminent regardless of the action taken in Congress in the next few weeks. Nor is the end to building manpower and material shortages in sight, particularly with the large volume of nonresidential construction underway and planned for civilian and defense purposes. A full scale rearmament program obviously would complicate the entire homebuilding situation by introducing a new wave of inflationary psychology affecting both short- and long-run housing values. Thus far in the Seventh District, however, no appreciable change has developed in this regard. In any event, inability to finance a continued record volume of home construction from private sources definitely is a factor which must be considered in assessing new housing prospects.

Banks Adjust to Tighter Money Market

Heavy Tax Receipts Accompanied by Reduced Support Operations

The first quarter of 1948 was characterized by four major influences on general credit conditions and the supply of money—heavy tax collections by the Treasury, accelerated debt retirement, further upward adjustment in short-term interest rates, and continued operations on the part of the Federal Reserve System and the Treasury to support the market for Government securities. The quarter was also marked by a decline in business loans of reporting member banks.

Purchases of Treasury bonds by the System Open Market Account and the Treasury investment accounts to stabilize the Government market fell off sharply in March. Total Federal Reserve acquisition of bonds in the market in the month amounted to less than 200 million dollars, and the Treasury purchases were even smaller. The accompanying table, which analyzes the shifts in ownership of the major classes of public marketable Government securities, indicates broadly the extent to which the Treasury and the Reserve System have absorbed bonds from the portfolios of banks and other investors since the beginning of the support program in early November. These figures, however, include not only market support transactions but also purchases by the Reserve Banks of some short-term bonds sold by commercial banks as a means of adjusting their reserve positions. Changes shown, furthermore, take into account the retirement and refunding of marketable securities.

Total support purchases from November 12 through March 31 are estimated at approximately six billion dollars, of which almost five billion were acquired before the end of January. There were no purchases by the Treasury in January, but the Reserve System continued to buy bonds in substantial volume. In February, purchases slackened markedly and by March were reduced to a negligible amount.

The reduction in official purchases in 1948 reflected the recovery in bond prices, particularly for the bank-eligible issues, to points somewhat above the Federal Reserve support levels. Even the bank-restricted war loan 2½'s and 2¼'s were above the support prices by the end of March. Trading in all issues, however, remained light.

SURPLUS USED FOR DEBT RETIREMENT

The Government security market in the first quarter of 1948 reflected not only support operations but also continued debt retirement by the Treasury, which used some 4.4 billion dollars of its cash surplus to pay off maturing marketable issues. Well over half of this amount, 2.7 billion, represented the retirement of certificates, 1.2 billion of bills, and 500 million of bonds. As part of its program of restricting further credit expansion, the Treasury retired 3.7 billion of issues held by the Federal Reserve Banks.

None of the issues maturing since the first of the year was completely paid off in cash. Exchanges were made for the three certificate maturities in the amount of 6.5 billion dollars of new certificates; the exchanged portion of the two per cent and 2¾ per cent bonds maturing March 15, 1.9 billion, was also refunded into the new certificate issue dated March 1. The 1⅛ per cent certificate rate established January 1 was maintained throughout the quarter and for the April refunding. The rate of discount on three-month Treasury bills continued to increase gradually, reaching .997 per cent for the April 8 issue.

At the end of March the Treasury's general fund balance was 5.4 billion dollars. It was reduced to under five billion as a result of cash retirement of the April 1 certificates. Part of this balance will undoubtedly be used for further cash repayments in coming months, but recent developments indicate that additional funds available for debt reduction above those needed to cover securities presented for redemption at maturity will be severely limited. In view of the tax reduction (estimated at approximately five billion) and increased defense expenditures, indications point to a smaller surplus or a possible deficit in the fiscal year 1949. Cash available for retirement of the maturing marketable debt will thus be largely dependent on the proceeds of sales of savings bonds and notes and the issuance of special securities. The maximum amount of Series E savings bonds which individuals are permitted to purchase in any one year was recently raised from $5,000 to $10,000.

CHANGES IN OWNERSHIP OF GOVERNMENT SECURITIES
November 12, 1947 - March 31, 1948
(In millions of dollars)

Period	Federal Reserve Banks	Treasury Investment Accounts	Weekly Reporting Member Banks	Other Investors	Total Outstanding
Treasury Bonds					
Nov. 12 - Dec. 31	+ 2,115	+ 917	— 1,497	— 2,236	— 701
Dec. 31 - Jan. 28	+ 1,687	—	— 540	— 1,147	—
Jan. 28 - Feb. 25	+ 1,128	+ 94*	— 554	— 668	—
Feb. 25 - Mar. 31	+ 4	+ 118*	— 1,300	— 1,161	— 2,339
Treasury Notes and Certificates					
Nov. 12 - Dec. 31	+ 194	—	+ 167	— 107	+ 254
Dec. 31 - Jan. 28	— 830	—	— 43	+ 331	— 542
Jan. 28 - Feb. 25	— 1,359	—	— 435	+ 36	— 1,758
Feb. 25 - Mar. 31	+ 281	—	+ 336	+ 794	+ 1,411
Treasury Bills					
Nov. 12 - Dec. 31	— 1,801	—	+ 723	+ 584	— 494
Dec. 31 - Jan. 28	— 1,429	—	+ 679	+ 552	— 198
Jan. 28 - Feb. 25	— 721	—	— 53	+ 370	— 404
Feb. 25 - Mar. 31	— 432	—	— 884	+ 727	— 589
Total Government Securities					
Nov. 12 - Dec. 31	+ 507	+ 917	— 607	— 1,758	— 941
Dec. 31 - Jan. 28	— 572	—	+ 96	— 265	— 741
Jan. 28 - Feb. 25	— 953	+ 94*	— 1,042	— 261	— 2,162
Feb. 25 - Mar. 31	— 147	+ 118*	— 1,848	+ 360	— 1,517

*Estimated on the basis of Daily Treasury Statement.
Note: Figures for "other investors" include nonreporting member as well as nonmember banks, in addition to all other institutional, business, and individual investors.

BANK RESERVES UNDER PRESSURE

Accompanying the increase in the certificate rate by the Treasury, Federal Reserve authorities took two additional restrictive measures during the quarter. These were the increase in the discount rate from one per cent to 1¼ per cent late in January, thus retaining a ⅛ per cent penalty over the rate on one-year obligations, and the increase in reserve requirements for central reserve city banks from 20 to 22 per cent effective February 27.

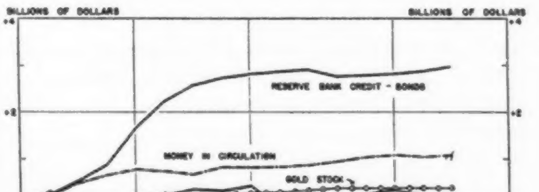
The major influences on the reserve position of member banks for the quarter are shown in the accompanying chart. Pressure on reserves exerted by Treasury operations was offset in part by the return flow of currency. This decrease in money in circulation was to some extent characteristically seasonal but was substantially larger than the corresponding period of 1947. Gold inflow continued to supply banks with reserves but at a slackened pace. At the same time, although banks in Chicago and New York had to meet the two point increase in reserve requirements, member banks in the country as a whole experienced a decline in required reserves primarily as a result of deposit withdrawals for tax payment purposes. The influence of the tax period was sharply apparent in the decline of 3.3 billion dollars in demand deposits adjusted of the weekly reporting banks.

As indicated in the table, early in the quarter weekly reporting banks increased their holdings of short-term securities, particularly bills; and despite sales of bonds amounting to over 500 million, total Governments of these banks showed a slight increase in the four weeks ended January 28. In February and March, however, additional pressure on reserves exerted through tax payments used for heavier repayment of Federal Reserve held debt made it necessary for banks to make net sales of all types of Governments. As a consequence of the support of Government security prices and the decline in short-term holdings of commercial banks, even long-term bonds became an appropriate instrument for adjusting reserve positions. There was also a considerable amount of borrowing to meet temporary reserve needs. A large part of the decline in bills held by reporting banks in the last week of March is attributable to the demand for bills at Illinois banks by customers in anticipation of the Illinois personal property tax date on April 1. The net result of the forces which dominated the period was an increase in the liquidity of bank investment portfolios.

MAJOR INFLUENCES ON EXCESS RESERVES OF MEMBER BANKS

CUMULATIVE WEEKLY CHANGES, DECEMBER 31, 1947 TO APRIL 14, 1948

(+ OR – INDICATES EFFECT ON EXCESS RESERVES)



Reserve Bank credit, as illustrated in the chart, declined over the three-month period by some 1.5 billion dollars. Total holdings of Government securities by the System were down 1.7 billion dollars. This reflected an almost steady decline in bills and certificates—largely through debt retirement operations—amounting to almost five billion and nearly double the expansion of bond holdings in connection with the support program. Discounts and advances by the Reserve Banks to both member and nonmember banks were 350 million greater on March 31 than at the end of 1947. To the extent that net reserve losses of member banks were not offset by borrowings, sales of Governments, and reduction in required reserves, excess reserves of these banks were allowed to decline to a level of 600 million on March 31.

Although total loans made by the weekly reporting member banks showed a slight expansion in the period, commercial, agricultural, and industrial loans declined 240 million dollars, most of which appears to have taken place in New York. This contraction, which occurred steadily since the end of January, represents a reversal of the strong upward trend in these loans during 1947. Some of the decline may be attributed to seasonal influences. It may also reflect some tightening in the supply of funds in response to the restrictive measures taken by the monetary authorities, a slackening demand for funds accompanying recent economic and political developments, and growing concern by bankers themselves about their loan positions. Real estate loans continued to grow.

Attention is once again being focused on the desirability or need for granting additional powers to the monetary authorities to curb credit expansion, despite the apparent decline in business loans in recent months. The amount of deflationary debt retirement in view of budgetary prospects in the months ahead is likely to be small. Moreover, resumption of support operations would continue to act as a counteracting force to any restrictive measures applied. Some further measure of restraint on credit and monetary expansion can be undertaken without additional powers. The Treasury can tighten credit conditions by raising the interest rate on new short-term securities which will replace the maturing issues. In addition, the Reserve authorities under the present law have the power to raise reserve requirements in New York and Chicago to the 26 per cent maximum.

States and Localities Increase Debts

Resources Rather Than Needs Limit Borrowing For Capital Outlays

The delayed action of inflation on the finances of state and local governments daily is becoming more manifest. The expected casual return to prewar conditions via the shelf of public works to ease reconversion unemployment is a fast fading mirage giving way to the realization that prewar levels of dollar expenditures may never seem excessive for the postwar period.

In substantial measure the earlier expectations have been upset by the inflation in the prices of most goods and services that states and local governments use. Awareness of the situation began as priorities on labor and material and price controls were relaxed, and the demand from the private sector of the economy was sufficient to push prices and costs sharply upward.

While the states and localities shortly discovered they were not immune to the effect of such pressures, they have more or less successfully waged a delaying action on rising costs in the expectation of a reversal in price trends. Thus increases in pension allowances recognize tardily, if at all, an equivalence to prewar real payments. Construction programs of all types have been deferred, cut back, or abandoned. For a time much of the cost of inflation was shifted to public employees who were unable profitably to shift their employment either because of job specialization and long developed skills—characteristic of the school teachers for example—or because of the status acquired during many years of prior service and equities in pension systems.

Many of these temporizing policies have nearly spent themselves as the sharp spurt in state and local expenditure attests. An authoritative estimate indicates that:

> State and local governments have increased their annual rate of spending by about five billion dollars over the last two years. A large part of this increase has been required to raise state and local salary scales to the levels prevailing in competitive private employments. Another large part has been needed to make up for accumulated deficiencies in plant and equipment resulting from the postponement of replacements and curtailment of maintenance work and new construction in war years.[1]

Even this indicated increase of approximately 50 per cent in state and local expenditures within a two-year period appears far short of the upward adjustment required if the relative position in the national economy of state and local expenditures in prewar years is restored. The major adjustment which largely remains to be made has to do with the reconditioning, reconstructing, and extending of the very substantial capital plant—the streets, highways, airports, water and sewerage systems, schools, hospitals, and other public buildings—that the states and localities require to perform their primary services.

Much of this plant, particularly that used by local governments, will be financed by the issuance of bonds. During the recent years of debt liquidation extending back through World War II and ending in 1946, the states and localities reduced their net debt to approximately 13.6 billion dollars from 17.2 billion. Since 1946 additional net borrowings are estimated to be between 1.5 and two billion dollars.

The relative significance of a state and local debt of 15 billion dollars at present price levels may be compared to the total of such debt in 1929 using a common denominator such as disposable income of individuals. The debt stood at 16.6 per cent of disposable income in 1929 compared to about nine per cent today. Disposable income is net of personal taxes, and it has been suggested that the restoration of earlier relative levels of municipal borrowing indicates an approach to a 30 billion dollar net state and local debt—about double the present outstanding amount.

How much money do these governments need to modernize and expand their capital plant? At what rate will the expenditure be made? In contrast to borrowings in prewar years and relative to outlays from current revenues, what will be the demands on the capital market? Are the limiting factors to be found in an analysis of the needs for capital plant or in the capacities of the states and localities to pay for it? Is there some rule of thumb relationship that affords a proximate indication of the rate of public construction or the size of the debt likely to be incurred for such purpose?

A full answer to most of these questions entails a general economic forecast and a political forecast of the future role and functions of the states and localities. A full answer requires data on the fiscal affairs of state and local governments which are not now and never have been available. But essential elements to understanding the problem in its life-sized background are contained in the character of these government institutions, their functions and resources.

NEEDS VERSUS RESOURCES

Various sources of data are available which afford rough indications of certain officially recognized needs for public construction. The Federal Works Agency, for example, through its Bureau of Community Facilities has been aiding the states and municipalities in preparation of plans for all types of public improvements other than housing projects and Federal aid highway programs. The estimated cost of such planned construction is indicative of the serious intent of local communities to engage in certain types of public works in the immediate future. Not even all eligible projects are referred to this Agency as the incentive to the use of its facilities is merely a loan

[1]Committee on Expenditures in the Executive Department, U.S. Senate, *Coordination of Federal and State Taxes*, Report 1054, 80th Congress, 2nd Session, p.1.

of the funds required for the preparation of specific plans. Consequently, the total estimated cost of construction of projects for which plans have been prepared of two billion dollars as of December 31, 1947, adequately covers only two or three segments of proposed public construction. A more comprehensive estimate appears in the *Engineering News Record.* It reported proposed state and local construction of all types as aggregating 20.4 billion dollars as of December 31, 1947.[2] There were, however, no plans or only very preliminary plans for a large part of this total.

Other estimates of needed improvements are based upon the assumption that the rates of public construction in some previous period can be used to estimate deferred construction during the depressed 1930's and the war years. Philip B. Fleming, Administrator of the Federal Works Agency, arrives at an estimate of 29 billion dollars using this method but sets the over-all need for public construction at 75 billion dollars.

> The deficit in State and local public works construction, to mention only these, which accrued during the depressed 30's, was found aggravated by the curtailment of normal construction operations during the war years. After the war public construction has been still further deferred to give priority to housing and other types of private construction. If the 1930 construction rate for State and local projects had been continued in the period from 1931 through 1946,—and 1930 is selected because it was the year the slide began,—State and local governments would have in use today around 29 billion dollars additional in the way of needed schools, hospitals, sewer and water systems, roads, recreational facilities, and all other public facilities. This figure gives some indication of the extent to which public works have been under-built in the past decade and a half.
>
> It is natural then that estimates of needs should be very large. While it is difficult to set an exact figure, existing inventories and preliminary estimates indicate that the dollar volume of needed new State and local public construction could conservatively approximate 75 billion dollars. If we include needs for urban redevelopment, this figure would have to be greatly expanded.[3]

Still another quantitative approach is to estimate the value and condition of the state and local government plant and from these data infer the annual requirements to maintain that plant in workable condition and provide for its modernization and extension. Again satisfactory data are not available. Some recent estimates of construction assets belonging to states and localities indicate that their reproduction cost (1946 prices) less depreciation is between 50 and 60 billion dollars. Approximately half of this inventory consists of streets and highways, about 20 per cent of water and sewerage systems, and about 30 per cent of nonresidential buildings. Many of these improvements have a long physical life, but the inventory is over age because of the low rate of replacement in the past two decades, and a realistic recognition of obsolescence suggests the remaining period of useful life is comparatively short. A replacement need in the neighborhood of five billion dollars annually (about double the 1947 rate of construction) is indicated.

Any of these expressions of the quantities involved in maintaining intact the capital plant of state and local governments ignores the implications of recent trends in the scope and functions of these governments. They particularly ignore the possibilities of large expenditures for public housing, for urban redevelopment, for municipal transit systems, and for a variety of quasi-public functions. The potential capital requirements involved could easily prove as significant to public construction and borrowing in the 1950's as was the development of hard roads in the 1920's. For these purposes "backlogs" and prewar construction rates provide no pertinent guides.

It is not likely that assaying the needs of state and local governments will do more than determine the upper limit to their demands for capital funds. Rather, they can be expected to limit their plans for new construction to as much as they can pay for from taxes, earnings, and Federal grants. The rate at which public outlays occur will be determined by such temporary factors as the condition of the security markets, the availability and cost of labor and materials, and in the long-run the willingness of voters to prefer higher taxes to higher personal expenditures.

STATE RESOURCES

States are comparatively uninhibited in their postwar capital expenditure programs by lack of resources. Their sense of financial well being is probably best evidenced by the alacrity and ease with which the prosperous Middle-Western and Eastern states have borrowed unprecedented sums for the payment of cash bonuses for veterans. While the geographical pattern of bonus issues closely resembles that following World War I, and no doubt serves as a powerful precedent, the financial condition and capacity of the states at the end of the war was also a major determinant, particularly in fixing the over-all cost. Up to the present time states have authorized issues totaling 1.5 billion dollars for cash bonuses; an additional 200 million has been authorized for veterans loan programs. Referenda on 140 million will take place in 1948, and there are half a dozen states in which proposals aggregating approximately one billion dollars are yet to be acted upon by the legislatures. The total of all authorized borrowing and of proposals in states where approval can be obtained is 2.9 billion dollars. This very substantial addition to state debt in the immediate postwar years is not likely to be matched by state borrowing for any other function.

Many of the states can finance a modest construction program of public buildings and highways from the accumulated balances in their general and earmarked funds. In the aggregate this amount is between one and two billion dollars. In addition, the states count among their resources Federal grants for highways, airports, and hospitals.

Highways, the type of capital outlay of primary concern to the states, have been financed to a steadily increasing extent from current revenues. The trend is not likely to be reversed. In fact, it has not yet fully run its course as debt service is still required for issues of the late 1920's and early 1930's. In those states where an extensive reconstruction program is launched there may be

[2] *Engineering News Record,* February 19, 1948, p. 120.
[3] *Some Essentials of Public Construction Policy,* Address before American Municipal Association Annual Conference, New Orleans, Louisiana, November 4, 1947.

some resort to borrowing. However, increases in the rates of gasoline taxation and in the license fees for passenger automobiles and trucks are generally more acceptable alternatives than highway bond issues. While there has been some upward revision in the highway user taxes, the increase since 1940 (five per cent for motor fuel taxes) has not been in anything like the same proportion as the rise in the cost of highway construction and maintenance.

Should the states generally become concerned with any substantial program of public works, they are likely to have only an indirect and marginal interest in financing them. On housing and urban redevelopment projects, for example, they would hardly heavily mortgage their tax systems even if there were no constitutional limitations on borrowing and no long standing traditions of current finance. The states have probably already made their major postwar incursion into the capital market. Once the balance of veterans cash bonus issues has been sold, the supply of new state securities is likely to be rather small.

RESOURCES OF LOCAL UNITS OF GOVERNMENT

Generally speaking, the financial resources of the localities (counties, townships, school districts, cities, villages, and special districts) are regarded by the corporate authorities of these units as inadequate to finance the traditional local functions. The adjustment of current operating costs to postwar price levels now in progress is acutely painful politically and has no doubt aroused much envy for a tax system that automatically responds to inflation. The resistance to absolute increases in property taxes, the major resource of local governments, has made it difficult for the majority of them to consider any kind of pay-as-you-go finance for their capital outlays. The attempts to provide other tax elements to municipal revenue systems have yet to afford any appreciable margin over pressing immediate needs.

Deficit financing, long a favored and established characteristic of local governments, is actually encouraged if not fostered by the peculiar character of property tax administration and institutions. For example, the typical system of tax rate limitation exempts tax levies for debt service even though the proceeds from such borrowing are devoted to the very functions the limitation against current spending was designed to restrain. This fact has encouraged many cities to prefer borrowing for almost any type of improvement and even for current expenses. Approval of bond referenda in prosperous times provides a comparatively easy method of increasing property taxes and avoids annual criticisms of the level of public expenditure. The only risk involved is that of securing voter approval of a particular project, and success means an irrevocable commitment good for the life of the issue.

Many needs for addition to and modernization of local facilities are as urgent as any other public or private construction requirements. The migration of population since the war and the housing boom have imposed very large burdens on municipalities to provide public facilities for new communities or for the shifts in population from one section to another of an established community. In some parts of the country the demand for such facilities cannot be postponed without a complete breakdown of school and other services.

Lack of financial resources will deter many communities from adequate programs of public construction whether financed from current receipts or borrowings. At the present, loans are the principal source of funds. In the past two years voter authorizations have been running at the rate of 1.9 billion dollars, and a substantial backlog is being built up. The older authorizations, however, include many projects that will remain inactive until construction costs are lower or until the authorization is increased or supplemented by grants or current revenues. Voter approval may become progressively harder to secure as the impact of higher property taxes is felt.

Unless the municipalities succeed in solving their financial problems they are not likely to furnish anything like the demand for public construction and capital funds indicated by their needs.

AGENCY AND REVENUE BORROWING

Some of the capital needs for urban public construction in particular are likely to be financed by means of revenue issues and through the creation of public corporate authorities with the power to incur debt, construct and manage various types of facilities, and to charge fees or rentals for their use. The revenue bond came into increasing use during the 1930's, and it was also during this period that many new corporate authorities, without the power of taxation but with most of the other financial attributes of local governments, were organized to perform public or quasi-public functions. Neither of these devices for financing public works has been fully developed. The capital market for such issues is somewhat less receptive than it is to general obligation issues, and constitutional obstacles have retarded the development of authorities in certain states. The corporate authority, however, does offer a convenient vehicle for financing a far greater volume of public construction than would likely be approved as general obligation debt.

In a degree, the possibilities of expansion seem to lie in schemes for providing equity cushions for such projects. Where earning prospects are good, probably no cushion other than tax exemption, including that on the interest from the authority's securities, is required. Projects with lesser potential earning capacities will require such additional equities as contributed sites, proportionate grants for construction costs, and the moral obligation of state and local sponsorship. These means by which the states and municipalities can improve the quality of agency securities without making them a general obligation secured by the full faith and credit of the sponsoring community are virtually unlimited. If fully developed the public authority seems to offer for the future a practical means of obtaining requisite funds adequately to finance the physical plant of local government, including that required for the newer functions of public housing, urban redevelopment, and metropolitan transportation.

FARM PRICES IN TRANSITION

(Continued from Inside Front Cover)

declines continued through the last half of 1920. The current situation is quite different. Sharp as the January to February break was, it has been generally reversed for March and April, and the factors covered in the following discussion do not suggest a further break at this time.

The whole price shakedown appears to have been for the most part a response to the generally improved world food grain situation and to possible declines in export volume. Acute and urgent buying of wheat in this country had put wheat at record levels, aided to some extent by the relatively short feed grain crop last year.

At the time, about the end of January, when the grain buying program was just moving past the hump, a series of reports became public knowledge. All of these tended to ease the grain price situation. In addition to a more optimistic report on U. S. winter wheat, reports on the crops in Argentina, Australia, and on winter crops in several important European areas all showed an improved supply prospect for the 1948 harvest.

The breaks which occurred touched off a psychology of readjustment, which spread to other commodities, including livestock, in a general "selling wave." Moreover, the livestock price situation was affected on the selling side by artificial situations tending to accentuate the declines, for example the alleged holding of meat animals on farms, especially hogs and cattle, until calendar 1948 in order to obtain the benefits of lower income taxes in 1948. Rumored consumer resistance to the level of meat prices at that time may have been a factor.

FARM PRICES TOO HIGH?

It is evident from the chart that the whole period since the end of World War II has been characterized by an upward movement in prices. Mention is made below of factors that appear now to be likely to continue this trend for some time to come. In addition to being high due to the general inflation situation, the farm price level is relatively above a normal or typical relationship to other prices.

During the war years the level of farm prices was at substantially the same relationship to other wholesale prices as prevailed during American participation in World War I. But during 1946 and 1947 the farm commodity price level was 18 per cent higher than its relationship to the level of other wholesale prices during the corresponding inflationary two-year period 1919-20. Farm prices in 1946 and 1947 were 37 per cent above the level of relationship to other wholesale prices that prevailed in 1935-39. Since the price declines beginning in February the level of farm prices has dropped relative to other prices, but if the 1935-39 relationship be taken as normal, farm prices are still nearly 30 per cent above the level that would be normal in relation to other prices.

This difference might be taken as a rough measure of the farm price adjustment that remains to be made in a return to normal price relationships if it were not for the question of a possible long-run change in demand for and supply of farm products. There is nothing either sacred or immutable about any set of price relationships in a dynamic economy, and the evidence of the last five years has been suggestive of a strengthening of demand for farm products and the capacity of the nation's agriculture to expand output.

There are three important aspects to the high domestic demand. One was the absence during wartime and since the war of a full and normal outlet for consumer expenditures. Even today consumer goods production has not reached levels for all lines that permit all consumers to satisfy needs and wants at rates that before the war had established the American plane of living. Secondly, the emphasis placed on food economy and efficient optimum nutrition during this period may have resulted in a permanently higher evaluation and demand for food. Thirdly, high personal dollar incomes for some people during this period introduced them as consumers to kinds and qualities of farm products that they had never before known.

There may be some degree of permanence to this increase in demand. A larger and growing population is an additional strengthening demand factor.

If such factors have strengthened demand, they will delay for some time the return of farm prices to previous relationships to other prices. But in the longer run it is to be expected that farm production will be adjusted to meet this demand. It is probable, aside from collective Governmental action to bolster farm prices, that the long-time trend will be in the direction of lowering the ratio of farm prices to other prices because more and more processing and services, involving added costs, are coming between the farm producer and the consumer.

DEMAND TO REMAIN HIGH

Apart from the above considerations of relative prices, the evidence currently points to continued strong demand and good prices for most farm products. As long as employment and incomes remain high, it may be expected that demand for farm products will also stay high. The recently much debated question of an impending recession appears to have subsided in the presence of continuing inflationary factors. Establishment of the European Recovery Program will help to sustain demand for farm products not only and not so much because of the direct shipments of food involved, but especially because of the indirect buying power created in this and other countries by the program. The effect of this buying power will be indirectly felt on the farm economy, but will be nonetheless real. The 1948 tax cuts and the probable step-up in Federal expenditures for defense, through the lowered cash surplus, or possible further deficit financing they imply, are other inflationary factors that can be expected to bolster farm prices, even if less than other prices.

Further declines in farm prices generally may occur within the next several months, especially with declining farm exports, bringing their level more nearly in line with other prices, but any postwar collapse comparable to that of 1921 appears for the present to be indefinitely postponed by force of currently strong factors.

SEVENTH FEDERAL

RESERVE DISTRICT